

This letter concerns sales of music and videos downloaded from the Internet. See 86 Ill. Adm. Code 130.101. (This is a GIL.)

June 18, 2007

Dear Xxxxx:

This letter is in response to your letter dated October 5, 2006, in which you request information. We apologize for the delay in responding to your inquiry. The Department issues two types of letter rulings. Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at www.ILTAX.com to review regulations, letter rulings and other types of information relevant to your inquiry.

The nature of your inquiry and the information you have provided require that we respond with a GIL. In your letter you have stated and made inquiry as follows:

On behalf of our client, CLIENT, we are requesting an opinion regarding the proper application of Illinois Retailers' Occupation Tax, Service Occupation Tax, Service Use Tax and Use Tax (collectively 'Illinois sales and use tax') to transactions involving the sales or transfer of digital codes which entitle purchasers to access and download digitized content (i.e. music and video files) which will be delivered electronically over the Internet.

FACTS

CLIENT, headquartered in STATE, is engaged in the business of electronic distribution via the Internet of digitized content (video and audio files) which is sold to customers located throughout the United States. Customers purchase digitized content from CLIENT's online store using their personal computers or an iPod. The content is delivered to the customers electronically in digital form and may be stored on the customers' computer hard drive or other electronic devices. Customers are then able to access the content and play the music, video or other content on their computer or other device. The downloaded music files remain on the customer's computer and may be copied to a limited number of CD's, other personal computers and/or personal electronic devices. Customers pay for the digitized content in one of a number of ways, including with a credit card serviced by a third party institution.

CLIENT is considering a number of marketing alternatives that would allow customers to download digitized content by redeeming digital codes. As referred to herein, a 'digital code' is an alphanumeric code which provides the holder with the right to electronically download a music or video file. Digital codes can be obtained by a variety of means, including via email, on printed paper certificates, imprinted on plastic cards, or contained on promotional items distributed by a third-party. For example, customers may obtain a digital code on a sales register receipt from an unrelated third-party retailer; from specially marked bottle-caps manufactured by an unrelated soda manufacturer; or from online promotions through which visitors to an Internet web site may register and obtain a digital code by viewing it online or in an email. However, in all cases, the customer's only objective in acquiring digital codes is to obtain the right to download digitized content which is delivered to customers by CLIENT via the Internet.

In some cases, digital codes printed on physical media will be sold through retailers. For instance, CLIENT and other third-party retailers will sell plastic cards imprinted with digital codes. In those situations, the digital codes on the physical media held for sale by retailers are not 'live' until activated. CLIENT produces the cards or other physical media at a nominal cost and transfers the possession of inactive cards, certificates, etc. to retailers at no charge.¹ Retailers hold and display the plastic cards or other media as inventory with zero value. Activation occurs when the code is scanned by the third-party retailer at the point-of-sale. At that time, the point-of-sale register 'pings' (sends an electronic signal) to CLIENT's server, which returns a signal indicating that particular digital code is now active. There is an automated, daily reconciliation of activation transactions. Based on that reconciliation of transactions, CLIENT generates an invoice billing the respective third-party retailer for a portion of the proceeds collected at the point-of-sale.

Once the digital code is activated, the plastic card or other tangible medium is no longer relevant and has no intrinsic value as an item. The activated digital code itself is the only item that has value, specifically, the value inherent in the right to download an audio or video digital file. Customers may redeem activated digital codes with or without possession of the card or certificate itself. Indeed, once the code is entered into the user's computer, the plastic card (or other medium) is of no further use even if the code is never redeemed and the digital content is not delivered.

CLIENT pays or remits the appropriate sales/use taxes applicable to its purchases of plastic cards or other media on which digital codes are printed.

ISSUES

1. Are transfers by CLIENT of physical media containing *inactive* digital codes to unrelated third-party retailers transfers of tangible personal property subject to Illinois Retailers' Occupation Tax?
2. Are downloads of digitized content subject to Illinois Retailers' Occupation Tax, Service Occupation Tax or use tax if the downloads are redeemed through digital codes printed on cards or certificates purchased by customers where the true object of the transaction is the download of digital content?

AUTHORITY

Illinois Department of Revenue Compiled Statutes Sec. 1 [35 ILCS 120/1]

‘Sale’ means and includes:

Any transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration. ‘Transfer of possession,’ includes only transactions found by the board to be in lieu of a transfer of title, exchange, or barter.

Archer Daniels Midland Company et al. v. City of Chicago et al.

Illinois courts have defined ‘tangible personal property’ to mean that which ‘may be seen, weighed, measured and estimated by the physical senses and which is capable of being possessed.

General Information Letter ST 04-0091 (June 21, 2004)

In a letter ruling pertaining to a taxpayer who distributed audio and video commercials in both electronic and physical media, the Department of Revenue described the transaction as a ‘mixed transaction’ and applied the true object test to determine taxability. In so doing, the Department of Revenue stated that, ‘[t]he true object test a subjective test to determine what it is the customer is really wanting to purchase, either services or tangible property. It is an all or nothing test. This test looks at the reason or purpose the buyer entered into the transaction and what it is the buyer wanted to purchase.’

Illinois Department of Revenue 86 Ill. Adm. Code 130.2105

‘Information or data that is downloaded electronically, such as downloaded books, musical recordings, newspapers or magazines, does not constitute the transfer of tangible personal property. These types of transactions represent the transfer of intangibles and are thus not subject to Illinois sales and use tax.’

General Information Letter ST 04-0189 (October 15, 2004)

In a response to a general information request regarding the viewing and downloading of text and similar data over the Internet the Department of Revenue responded that it did not consider such activity to be the transfer of tangible personal property.

General Information Letter ST 01-0157 (September 25, 2001)

In response to a letter ruling request regarding digital media electronically downloaded to the customers individual Personal Computer via the Internet, with no tangible product changing hands at the time of the download or in the future, the Department of Revenue responded by directly quoting 86 Ill. Adm. Code 130.2105, ‘Information or data that is downloaded electronically, such as downloaded books, musical recordings, newspapers or magazines, does not constitute the transfer of tangible personal property. These types of transactions represent the transfer of intangibles and are thus not subject to Retailers’ Occupation and Use Tax.’

General Information Letter ST 03-0041 (March 7, 2003)

In response to a letter ruling request, the Department of Revenue addressed the application of Illinois Retailers’ Occupation Tax on the sale of a prepaid card,

accompanied by a Start-Up CD, used for a specified amount of Internet access time. In its ruling, the Department of Revenue explained that while the transfer of canned computer software would generally be subject to tax, in the instant case, the transfer of the Start-Up CD 'is merely incident to the sale of Internet services. Therefore, no Retailers' Occupation Tax liability would normally be incurred on the transfer of that Start-Up CD.'

ANALYSIS

CLIENT's transfers of physical media (inactive cards or certificates) to Retailers are not 'sales' subject to Illinois sales or use tax

CLIENT's transfer of inactive codes to the Retailer is not a 'sale' under Illinois Department of Revenue Sec. 1 [35 ILCS 120/1], because no consideration is received for the transfers of physical media. As the transfer of inactive codes is not in exchange for consideration of any kind from the retailer (i.e., there is no *quid pro quo*), the transfer of inactive codes to unrelated, third-party retailers is not a 'sale' subject to Illinois sales tax, irrespective of the media on which the code is imprinted.

The redemption of digital codes used to acquire downloaded digital content is not subject to Illinois sales and use tax

The true object of the transaction when purchasing a digital code is the download of an intangible, specifically electronically downloaded music or video recording files. Illinois sales and use tax is applicable to sales of tangible personal property and certain enumerated services. The longstanding policy of the Illinois Department of Revenue treats digitized content delivered solely by electronic means as a transaction which does not involve the transfer of tangible personal property and is therefore not subject to Illinois sales and use tax. Illinois GIL ST-01-0157 clearly states, information or data delivered electronically via the Internet does not constitute the transfer of tangible personal property but rather the transfer of an intangible not subject to Retailers' Occupation and Use Tax. Accordingly, the sale of a digital code delivered by electronic means should not be subject to Retailers' Occupation and Use Tax, because the object of the transaction, the electronically delivered music or video recordings, is an intangible. Similarly, the redemption of a digital code printed on a tangible medium should not alter the applicability of Illinois sales and use tax when otherwise non-taxable transfers of digitized content are sold.

Regardless of the medium used to deliver an activated digital code, the true object of the transaction at issue is the purchase of a right to access and download digitized content from CLIENT's website via the Internet. The card, certificate or other physical medium on which the digital code is printed is simply temporary repository of the digital code until the electronic download of content is realized. Accordingly, the true object of the transaction in a purchase of an activated, redeemable code is the transfer of music or video recordings delivered via the Internet. Therefore, Illinois sales and use tax should not apply to the sale of a plastic card, paper certificate or other medium incidental to the digital transfer of music or video recordings delivered over the internet.

CONCLUSION

We respectfully request the Illinois Department of Revenue issue a Letter Ruling stating that sales of cards, certificates or other media encoded with digital codes granting the

right to access and download digitized content delivered electronically via the Internet constitute non-taxable sales under Illinois sales and use tax provisions. Prior to the issuance of the Illinois Department of Revenue ruling we also request the opportunity to discuss the complexities of CLIENT's fact pattern in person with representative(s) of the Illinois Department Revenue.

In the event that the Illinois Department of Revenue intends to either deny issuance of the requested Letter Ruling or issue a ruling that the sale of the activated codes are subject to Illinois sales or use tax, we respectfully request to be notified before the issuance of such Ruling and be given the opportunity to withdraw this request for Letter Ruling.

Please contact me at your earliest convenience so that we may schedule a time to further discuss CLIENT's situation, answer any questions, and provide additional documentation you require.

DEPARTMENT'S RESPONSE:

The Illinois Retailers' Occupation Tax Act imposes a tax upon persons engaged in this State in the business of selling tangible personal property to purchasers for use or consumption. See 86 Ill. Adm. Code 130.101. In Illinois, Use Tax is imposed on the privilege of using, in this State, any kind of tangible personal property that is purchased anywhere at retail from a retailer. See 86 Ill. Adm. Code 150.101. These taxes comprise what is commonly known as "sales" tax in Illinois.

The sale of electronic downloads of music or video from the Internet is not considered the sale of tangible personal property for purposes of liability under the Retailers' Occupation Tax Act and Use Tax Act. Please note that canned computer software is considered to be tangible personal property regardless of the form in which it is transferred or transmitted, including tape, disc, card, electronic means, or other media. Computer software that is purchased via a download over the Internet, assuming it does not meet the specific requirements of licensed software under Section 130.1935(a)(1), is taxable as a retail sale in Illinois. See 86 Ill. Adm. Code 130.1935.

The sale of plastic or paper cards with codes or numbers imprinted on them that allow the purchaser to access or download music or video over the Internet would not generally be considered a sale of tangible personal property and would not be subject to tax under the Retailers' Occupation Tax Act and Use Tax Act. Please note that this principle is based on the fact that the plastic or paper cards have no value or use to the purchaser other than for the purpose of obtaining the codes or numbers imprinted on them to allow the purchaser to download music or video from the Internet. This principle will not apply if the plastic or paper cards or other tangible media have any use or value to the purchaser beyond the obtaining of such numbers or codes.

I hope this information is helpful. If you require additional information, please visit our website at www.ILTAX.com or contact the Department's Taxpayer Information Division at (217) 782-3336. If you are not under audit and you wish to obtain a binding PLR regarding your factual situation, please submit a request conforming to the requirements of 2 Ill. Adm. Code 1200.110 (b).

Very truly yours,

Terry D. Charlton
Senior Counsel, Sales & Excise Taxes

TDC:msk

¹ Generally cards are produced at a nominal cost that can range from approximately 0.08% to 1.5% of the total sale price of the digital content accessed through the digital code once activated.